No. 12928

In the United States Court of Appeals for the Ninth Circuit

ESTATE OF HERBERT B. HATCH, DECEASED, JUANITA O. HATCH, EXECUTRIX AND AMERICAN TRUST COMPANY, EXECUTOR; JUANITA O. HATCH AND HERBERT B. HATCH, JR., PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

ON PETITION FOR REVIEW OF THE DECISIONS OF THE TAX COURT OF THE UNITED STATES

BRIEF FOR THE RESPONDENT

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OPINION BELOW

The findings of fact and opinion of the Tax Court (R. 67–74) are reported at 14 T. C. 251.

JURISDICTION

The Commissioner determined the following deficiencies in income tax: \$3,702.31 against the estate of Herbert B. Hatch, deceased, for the period January 1 to April 9, 1944; \$2,199.38 against Juanita O. Hatch for the calendar year 1944; and \$187.22 against Herbert B. Hatch, Jr., for the calendar year 1944. (R. 41.) Notices of the deficiencies were mailed to the taxpayers on February 20, 1948. (R. 14–19,

24–29, 34–38.) On May 17, 1948, within the permitted 90-day period, each taxpayer filed a petition for review with the Tax Court for a deficiency redetermination under the provisions of Section 272 of the Internal Revenue Code. (R. 3, 10–19; 5, 21–29; 7, 31–38.) The Commissioner filed an answer to each petition (R. 19–20, 29–30, 39–40) and a hearing was held in all three cases on May 10, 1949, when the cases were also consolidated on joint motion (R. 4, 6, 8). The decision of the Tax Court in each case was entered on December 28, 1950. (R. 75–77.) A petition for review by this Court covering all three cases was filed on March 23, 1951 (R. 5, 7, 9, 78–87), at which time, by stipulation of the parties, the cases were also consolidated for hearing and decision in this Court (R. 89–90). The Court accordingly has jurisdiction of the cases under Section 1141 (a) of the Internal Revenue Code, as amended by Section 36 of the Act of June 25, 1948.

QUESTION PRESENTED

Whether the sale involved was a sale of partnership assets, as the Tax Court held, or was a sale by taxpayers of their partnership interests, as taxpayers contend.

STATUTE AND REGULATIONS INVOLVED

The pertinent Statute and Treasury Regulations are set forth in the Appendix, *infra.*

STATEMENT

The facts as reflected solely by a stipulation of facts, including exhibits (R. 40–66), were summarized

by the Tax Court (R. 68–72) and may be restated as follows:

On December 1, 1942, Herbert B. Hatch, his wife Juanita O. Hatch, and their son Herbert B. Hatch, Jr., of Stockton, California, formed a partnership under the name of Hatch Chevrolet Company to engage for an indefinite term "in the business of selling, distributing, repairing, and servicing motor vehicles and motor vehicle parts both at wholesale and retail."[1]

The business was operated under a franchise from the Chevrolet Motor Division of General Motors Corporation. The record does not show whether that franchise was either valuable or transferable. (R. 68–69.)

On February 16, 1944, the Hatches, "as co-partners transacting business under the firm, name and style of Hatch Chevrolet Company", parties of the first part, executed an "Agreement of Sale" (Ex. 2–B, R. 51–55) with King M. Chase, party of the second part, providing in part (R. 69–70):

> * * * that first parties will sell to second party all of the business and assets of Hatch Chevrolet Company, a co-partnership, hereinafter listed, and the transaction shall be escrowed until a complete inventory and appraisement has been completed. However, * * * said party of the second part shall take over possession of the physical assets of the business * * * on * * * February 21, 1944, and thence forward shall operate said business to all intents and purposes as though

[1] The partnership agreement (Ex. 1–A) is printed in the record at pages 45–51.

> this transaction has been completed and title thereto passed to the party of the second part.
>
> Second party shall, upon taking possession, have permission to operate the business under the name of Hatch Chevrolet Company for a limited period of time to enable him to make the necessary arrangements for the future title or trade name of said business.
>
> The tentative sales price of said business and assets is the sum of * * * ($175,229.51). This figure or amount may be appreciated or depreciated according to the results of the inventory to be taken.

The "statement" which is a part of the "Agreement of Sale" reflects only the items to be transferred to Chase pursuant to the agreement and is not a financial statement of the partnership. It does not include cash in bank retained by the partnership in the amount of $35,249.90, two automobiles having a book value of $1,542.66, and certain liabilities not assumed by the purchaser in the amount of $15,588.55. (R. 42.)

On March 3, 1944, the partners delivered a "Bill of Sale" (Ex. 3-C, R. 56-59) to Chase providing that they (R. 56)—

> as co-partners transacting business under the firm name and style of Hatch Chevrolet Company, the Parties of the First Part, in consideration of the sum of * * * ($161,807.77) * * * to them in hand paid by King M. Chase, the Party of the Second Part, the receipt whereof is hereby acknowledged, do by these presents sell unto the Party of the Second Part, his executors, administrators and as-

> signs, the following described personal property [listed in a schedule] * * *

The property transferred to Chase included all of the assets of the partnership except the General Motors franchise, two automobiles, cash in a substantial amount, and the partnership name. Chase assumed a part, but not all, of the liabilities of the partnership. (R. 70.)

Chase paid $5,000 of the purchase price at the time of the agreement of sale on February 16. He paid the remainder of the purchase price, $156,807.77, by check (Ex. 4–D, R. 60) dated March 3, 1944, payable to the order of the Hatches, "Co-Partners" (R. 70).

The assets of the partnership which were sold to Chase were not distributed in kind to the Hatches prior to the sale thereof. Chase's check dated March 3 was credited to the bank account of the Hatches, "Co-Partners," on March 6, 1944. Partial distributions were made to the Hatches by checks drawn on that account beginning in June 1944. (R. 42–43, 70–71.)

The stipulation of facts states that "The interests of the partners or the assets of the partnership (as the Court may determine) which were sold to Chase had a total cost basis of $125,138.70 and the gain on the sale was $36,669.07." (R. 42, 72.)

Herbert B. Hatch died a resident of Stockton, California, on April 9, 1944. Juanita O. Hatch and American Trust Company are the executrix and executor, respectively, under his last will and testament. (R. 71.)

In its amended return for the fiscal year ended June 30, 1944, filed on September 19, 1944, the partnership reported the $36,669.07 gain on the sale to Chase as a long-term capital gain, $18,334.54 of which was taken into account and divided as follows (R. 71):

Herbert B. Hatch	$9,778.42
Juanita O. Hatch	7,089.35
Herbert B. Hatch, Jr	1,466.77

The Hatches separately reported those amounts on their respective individual returns for the taxable periods involved as "Gain or loss to be taken into account." (R. 71.)

The Commissioner allowed the partnership a long-term capital gain from the sale to Chase in the amount of $22,486.36 (recognized to the extent of $11,243.18); determined that the remaining gain from the sale, in the amount of $14,182.71, was ordinary income to the partnership from the sale of property other than capital assets; and made corresponding proportionate adjustments in the individual income of Herbert B. Hatch, Juanita O. Hatch, and Herbert B. Hatch, Jr., for the taxable periods involved, on the ground that "the transaction constituted a sale by the partnership of assets held pursuant to its business; that the * * * [accounts receivable and inventories] transferred in the sale were not capital assets under section 117, Internal Revenue Code, and gain realized thereon was not long-term capital gain". (R. 71–72.)

The Tax Court sustained the Commissioner's deficiency determinations. (R. 72–74.)

SUMMARY OF ARGUMENT

Under Sections 181, 182 and 183 of the Internal Revenue Code partners are required to pay tax in their individual capacities on their distributive shares of the ordinary income and capital gains of the partnership, whether distributed to them or not. Accordingly, the partners are taxable on the gain from the sale of partnership assets just as though they were the individual owners of the partnership assets; in other words, according to the nature of the gain on each individual asset, as long-term capital gain recognizable to the extent of 50 percent or as ordinary income. In the present case there was concededly a sale of partnership assets, but taxpayers are contending that the sale was in substance and effect a sale of their partnership interests. They make this contention because the sale of a partnership interest has been held to constitute the sale of a single capital asset and acceptance of the contention would make taxpayers' gain taxable as long-term capital gain, only 50 percent of which is recognized, instead of partly as capital gain and partly as ordinary income.

The sale of partnership assets was not transformed into a sale of taxpayers' partnership interests simply because the sale covered most of the assets of the partnership business and therefore could loosely be called a sale of the business. A partnership interest consists of the right to share in the surplus after payment of partnership debts and a sale of the partnership business does not terminate that right. In the present case, for example, partial distributions of the

proceeds of the sale were made not less than three months after the sale and from the partnership bank account. Taxpayers, as the partners, could have started another business. That they did not choose to do so, and apparently ultimately terminated the partnership, is no basis for a conclusion that the sale to Chase was of their partnership interests. The sale of a partnership business is merely a sale of partnership assets in liquidation of assets of the partnership. Under Section 182 the sale has the same effect as to the partners as the sale of a sole proprietorship business to the proprietor thereof. Such a sale has been held not to be the sale of a single asset consisting of the business but, instead, is to be comminuted into its fragments and matched against the definitions contained in Section 117 covering the sale of capital assets.

None of the decisions relied upon by taxpayers gives any real support to their position. Most of the cases involved what was concededly the sale of a partnership interest from one partner to another, not the sale of a partnership business. Only two cases involved the sale or exchange of a partnership business and they were both cases in which the partners incorporated their business. In one of the cases, *Commissioner* v. *Whitney,* 169 F. 2d 562 (C. A. 2d), certiorari denied, 335 U. S. 892, the transaction was not regarded as a sale or exchange of a single capital asset. In the other case, *Thornley* v. *Commissioner,* 147 F. 2d 416 (C. A. 3d), the question was as to what one of the partners had exchanged for the stock he re-

ceived in the corporation. It was held that he had exchanged his partnership interest for the stock, but in view of the more recent decision of the same circuit in *Randolph Products Co.* v. *Manning,* 176 F. 2d 190, it is clear that the *Thornley* decision, if not now incorrect, should be limited in its application to the precise question there presented for decision.

Taxpayers are in no better position even if it be assumed that the *Thornley* decision is to be accepted as authority for a conclusion that the sale of a partnership business may constitute the sale of the partners' partnership interests. What was regarded as an exchange of a partnership interest for stock in the *Thornley* case was an exchange of the taxpayers' interest in the entire business as a going concern, including good will. A partnership interest is no less than an interest in the business as already established as a going concern and no interest of that type was transferred in the instant case. The sale here was only of personal property, thus excluding the garage in which the business was conducted and which apparently was rented, and, more importantly, excluded essential elements of the business as a going concern—the name of the business, good will and the General Motors franchise under which the business was operated. All that happened here was that the partnership sold assets sufficient to enable the purchaser to set up a similar business. Accordingly, even if the sale of a partnership business may in some cases constitute a sale of the partners' partnership interests, this is not such a case.

ARGUMENT

The sale was of partnership assets, not of taxpayers' partnership interests

The Tax Court held that the sale to Chase was a sale by the partnership of assets of the partnership. (R. 72–74.) Taxpayers, the three partners (one of whom is deceased), contend that the sale was a sale by them of their interests in the partnership. (Br. 8–18.) The reason for the contention is that a sale of a partnership interest is a sale of a capital asset and, if this was such a sale, the gain on the sale was all long-term capital gain and only 50 per cent of it is taxable to taxpayers under Section 117 of the Internal Revenue Code (Appendix, *infra*). On the other hand, if the sale was of assets of the partnership, as the Tax Court held, the gain on the sale is taxable to taxpayers according to the nature of the gain to the partnership on each asset sold, with the result that only $22,486.36 (recognized to the extent of $11,243.18) was long-term capital gain and $14,-182.71 was ordinary income.

A partner's liability for tax on the gain from a sale of partnership assets according to the nature of the gain on each asset results from express statutory provisions dealing with partnership income. Section 181 of the Code (Appendix, *infra*) provides that individuals carrying on business in partnership shall be liable for income tax only in their individual capacity. Section 183 (Appendix, *infra*) provides that the net income of a partnership shall be computed in the same manner and on the same basis as in the case of an individual, with exceptions which include the segre-

gation of capital gains and losses. The subject of capital gains is covered by Section 117, which, among other things, defines "capital assets" and provides for recognition of 100 per cent of the gain on a sale or exchange of a capital asset held for not more than six months and for recognition of only 50 per cent of the "long-term capital gain", consisting of gain from the sale or exchange of a capital asset held for more than six months. Section 182 (Appendix, *infra*), entitled "Tax of Partners", provides:

> In computing the net income of each partner, he shall include, whether or not distribution is made to him—
>
> (a) As part of his gains and losses from sales or exchanges of capital assets held for not more than 6 months, his distributive share of the gains and losses of the partnership from sales or exchanges of capital assets held for not more than 6 months.
>
> (b) As part of his gains and losses from sales or exchanges of capital assets held for more than 6 months, his distributive share of the gains and losses of the partnership from sales or exchanges of capital assets held for more than 6 months.
>
> (c) His distributive share of the ordinary net income or the ordinary net loss of the partnership, computed as provided in section 183 (b).

Accordingly, the partnership is treated only as an accounting entity and the net income and capital gains "of the partnership" are taxed to the individual partners as though they were the individual owners of the partnership assets. See *Commissioner* v.

Whitney, 169 F. 2d 562 (C. A. 2d), certiorari denied, 335 U. S. 892. The nature of the gain on a sale of assets of the partnership is determined according to the nature of the individual assets sold, just as in the case of a sale by an individual, and the resulting capital gain and ordinary income of the partnership are taxable to the partners as capital gain and ordinary income respectively.

It should perhaps be emphasized at this point that, when the sale is of assets of the partnership, it is immaterial whether the sale is regarded as made by the partnership or by the partners as individuals. If the partners are regarded as the owners of the partnership assets, they of course as individuals would be taxable on their gain on each asset sold according to whether the gain was capital gain or ordinary income. What Section 182 does is to make the partners taxable in the same manner, as individuals, on capital gain and ordinary income "of the partnership".

Taxpayers concede (Br. 9), as they must, that the instant sale was of assets of the partnership. The bill of sale (R. 56–59) states that the sale is of "the following described personal property" (R. 56) and describes that property as follows (R. 56–57):

> All that property set forth and described in the Inventories listing said personal property—
>
> (1) Parts Department Inventory consisting of 165 pages.
>
> (2) Accessory Department and Miscellaneous Merchandise consisting of 18 pages.
>
> (3) Gas, Oil and Grease Inventory consisting of one page.

(4) Duco Material Inventory consisting of 5 pages.

(5) Work in Process & Sublet Repairs consisting of 5 pages.

(6) Tire Department Inventory consisting of 6 pages.

(7) Machinery and Shop Equipment consisting of 19 pages.

(8) Parts & Accessory Equipment consisting of one page.

(9) Furniture & Fixtures consisting of 7 pages.

(10) Service Cars (7) consisting of one page.

(11) Other Fixed Assets, consisting of one page.

(12) New Cars (4) consisting of one page.

(13) New Car Freight and Handling plus Increment consisting of one page.

(14) Used Cars (13) consisting of one page.

The Tax Court found (R. 70) that the sale covered—

> all of the assets of the partnership except the General Motors franchise, two automobiles, cash in a substantial amount, and the partnership name.

It may also be noted that the sale did not cover the good will of the business nor any real property and therefore not the garage in which the business was conducted.

It should follow without any argument that, as to the sale, the tax consequences to taxpayers are the tax consequences to the partnership. Section 182 requires taxpayers, the partners, to include the ordinary net income and capital gains of the partnership in their gross income, just as they would be required

to do if they were the owners of the assets sold, and the statute makes no distinction between a sale of a small portion, most, or all of the assets of the partnership.

Taxpayers contend, however, that in "substance and effect" the sale was of their partnership interests. (Br. 8.) The first, and most obvious, answer to that contention is that the sale was in actuality and substance a sale of partnership assets the effect of which is controlled by Section 182. The second answer is that, even if it were not for the express statutory provisions, the sale could not properly be construed as having the substance and effect of a sale of taxpayers' partnership interests.

Taxpayers' position seems to be that the sale was of their partnership interests because, as a result of the sale of most of the assets of the partnership, they terminated their interest in the partnership "business" and in the partnership (see Br. 9, 18–21, 24), although they also argue that the sale was of the business "as a going concern" (Br. 12). Neither the termination of taxpayers' interest in the business nor the termination of their interest in the partnership, the latter of which occurred not less than three months after the sale, has any bearing on the question of what was sold to Chase. Had all of the partnership assets been sold piecemeal, instead of to one person, taxpayers could not possibly deny the applicability of Section 182 even though the sales resulted in termination of their interests in the business and in a termination of the partnership. The mere fact that most of the assets were sold to one

person, and that the sale may therefore perhaps be termed a sale of the "business", does not establish that the sale was of taxpayers' partnership interests. The sale of a partnership business does not *per se* terminate a partnership nor the partners' interests in the partnership. It did not do so in this case. While taxpayers argue that it did (Br. 18–21), the facts found by the Tax Court show differently. The Tax Court found that the proceeds of the sale were deposited in the partnership bank account and that partial distributions therefrom were made beginning in June, 1944, which was three months after the sale. (R. 71.) If the partnership was later terminated, it was by voluntary act of the partners, who could have continued the partnership by engaging in some other business. The result of the sale of the "business" was simply to liquidate partnership assets. After the sale, taxpayers each still had a partnership interest ~~Accordingly, the sale of the "business" could~~ sisting of their interest in the surplus and profits of the partnership, including the proceeds from the sale. Accordingly, the sale of the "business" could not have constituted the sale of taxpayers' partnership interests.

Section 182 requires that the sale of a partnership business be treated in the same manner as the sale of a sole proprietorship business which, as the Second Circuit stated in *Williams* v. *McGowan*, 152 F. 2d 570, is not to be treated as the sale of a single piece of property but is "to be comminuted into its fragments" (p. 572) and matched against the definition in Section 117 (a) (1) to determine what part of

the gain on the sale is capital gain and what part ordinary income. A sale of partnership assets, even of the entire business as a going concern, is still a sale of partnership assets. The sale is necessarily made by either the partnership or the partners as owners of the partnership assets. If the sale is regarded as made by the partners as the owners of the assets (which taxpayers will deny), the partners' position as individuals is no different from the position of a sole proprietor. If the sale is not regarded as made by the partners as owners of the partnership assets, the sale is necessarily made by the partnership and Section 182 requires partners to pay tax on the capital gain and ordinary income "of the partnership" and thus to pay tax on the gain on the sale of any and all assets of the partnership according to the nature of the gain on the individual assets.

With the exception of *Thornley* v. *Commissioner,* 147 F. 2d 416 (C. A. 3d), which we shall discuss later, and *Commissioner* v. *Whitney, supra,* which really supports our position rather than taxpayers' and will also be discussed later, the decisions upon which taxpayers rely for their contention that the instant sale was of their partnership interests do not relate to the tax consequences of a sale of partnership assets or of a partnership business. The cases all involved what was concededly the sale of a partnership interest, by one partner to another person who either already was or became a partner, and the question was as to the effect of the sale of the partnership interest. See *Commissioner* v. *Lehman,* 165 F. 2d

383 (C. A. 2d), certiorari denied, 334 U. S. 819; *Commissioner* v. *Smith,* 173 F. 2d 470 (C. A. 5th), certiorari denied, 338 U. S. 818; *Commissioner* v. *Shapiro,* 125 F. 2d 532 (C. A. 6th); *Commissioner* v. *Estate of Gartling,* 170 F. 2d 73 (C. A. 9th); *Ford* v. *Commissioner,* 6 T. C. 499; and *Humphrey* v. *Commissioner,* 32 B. T. A. 280. There are other cases to the same effect, but of the Court of Appeals decisions only the *Lehman, Smith* and *Shapiro* cases, *supra,* discuss the subject.[2] The decisions all merely constitute a rejection of the Commissioner's contention that the sale of a partnership interest is nothing more than a sale of the selling partner's undivided interest in the individual assets of the partnership, the Commissioner having urged acceptance of the theory, since accepted for other tax purposes (see *Commissioner* v. *Whitney, supra;* and *Randolph Products Co.* v. *Manning,* 176 F. 2d 190 (C. A. 3d)), that a partnership is an aggregation of individuals rather than a legal entity. In the *Lehman, Smith* and *Shapiro*

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[2] This Court's decision in *Commissioner* v. *Estate of Gartling, supra,* merely affirmed *per curiam* on the authority of the Court's prior decision in *Stilgenbaur* v. *United States,* 115 F. 2d 283, which did not however expressly hold that a sale of a partnership interest is a sale of a capital asset. *United States* v. *Shapiro,* 178 F. 2d 459, which is not cited by taxpayer, is a case similar to the others in which the Eighth Circuit, without discussion of the question involved, merely followed what was stated to be the overwhelming weight of authority. *Long* v. *Commissioner,* 173 F. 2d 471 (C. A. 5th), certiorari denied, 338 U. S. 818, is another similar case not cited by taxpayer. On the pertinent point, that case was decided by reference to the same court's decision in *Commissioner* v. *Smith, supra.*

cases *supra,*[3] the cases which discussed the subject, the rejection of the Commissioner's contention was based on statements to the effect that a partner has no individual property right in specific assets of the partnership and that, instead, a partner's interest in the partnership or in the partnership assets is "his share of the profits and surplus" (*Commissioner* v. *Lehman, supra,* p. 385), "his share in the surplus, after the partnership debts are paid and after the partnership accounts are settled" (*Commissioner* v. *Shapiro, supra,* p. 535) and "in a proper proportion of the surplus of the whole after payment of debts, including the amounts due the other partners" (*Commissioner* v. *Smith, supra,* p. 470). In the *Smith* case, *supra,* it was added that (p. 470)—

> The taxpayer [by his sale of a partnership interest] here sold an intangible asset or chose in action, not his interest in the specific assets of the firm * * *.

Taxpayers are not aided by the holding in these cases that the sale of a partnership interest is more than the sale of an undivided interest in the partnership assets. That holding implies that a sale of partnership assets is not a sale of a partnership interest, whereas taxpayers are contending that it is in this case.

If a partner has no individual property right in the specific assets of the partnership (as distinguished from the undivided interest he has with the other

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[3] All references to the *Shapiro* case, *supra,* are to *Commissioner* v. *Shapiro,* 125 F. 2d 532 (C. A. 6th), as distinguished from the decision of the Eighth Circuit in *United States* v. *Shapiro, supra,* mentioned in fn. 2.

partners) and his interest is only in the surplus after payment of partnership debts, as the above-discussed cases hold, it must necessarily follow that a partner's interest is in the partnership as an entity. See *Commissioner* v. *Whitney, supra.* If the partnership is in business, the partner's interest includes the right to share in the profits and surplus of the business *with all of its assets as a going concern, including its name and its good will.* That is what is ordinarily transferred upon the sale of a partnership interest by one of the partners to a purchaser who either already is or who becomes a partner. Thus, in the *Shapiro* case, *supra,* where there were two partners each owning a 50 per cent interest in the partnership and one partner sold out to the other, the Sixth Circuit stated as follows (p. 535):

> The only question presented on the record is whether the sale of the assets of a partnership *as a going concern* is the sale of a capital asset * * *.
>
> Petitioner presses the point that the issue depends primarily upon the extent to which a partnership is to be regarded as an entity, separate and apart from its members. In our opinion, a decision of this more or less troublesome question would throw no light on the present controversy. The case must be viewed as though *the entire assets of the partnership with its value as a going concern added were sold.* The fact that a one-half interest in the partnership assets *and its good will* only were sold has nothing to do with the issue, and the further fact that the sale was from one partner to another has no more to do with the question

> than if the sale had been made to a stranger. * * *
>
> * * * * *
>
> The decision must turn on the meaning of the phrase, "capital assets" as that phrase is ordinarily understood. The term is not used in any technical sense, but in its natural and ordinary signification, and construing the phrase as used, *it means all capital invested plus all surplus accounts or undivided profits left in the business for the purpose of accumulating and being used in the business and in addition such good will as had been established and accumulated over the years of its existence.* The present partnership was dissolved by the sale under the fundamental principle that every change in the personnel of a firm works dissolution, and that an existing partnership is terminated and a new partnership formed whenever a partner retires or a new one is admitted, but where, as here, there is a sale of a part interest in the partnership *as a going concern,* no change is wrought in the character of the property sold. [Italics supplied.]

While this case reflects what the sale of a partnership interest covers, it should be noted that the case does not hold that the sale of a partnership business by the partnership (or by all of the partners) terminates the partnership interests of the partners and constitutes a sale of those interests. The sale in the *Shapiro* case was of a partnership interest by one partner to the other, and the sale naturally had the effect of terminating the selling partner's partnership interest. That a sale of the partnership busi-

ness by the partnership (or by all of the partners) does not have that effect is implicit in the statement of the court that a partner's interest is "his share in the surplus after the partnership debts are paid and after the partnership accounts are settled". (P. 535.)

Of all the cases relied upon by taxpayers, only *Thornley* v. *Commissioner, supra,* and *Commissioner* v. *Whitney, supra,* involved the sale of a partnership business by the partnership (or by all of the partners). Taxpayers ignore the result reached in the *Whitney* case and place their principal reliance upon the *Thornley* decision. In the latter case an advertising business conducted as a partnership under the name of "N. W. Ayer & Son" was incorporated under the name of "N. W. Ayer & Son, Incorporated" (p. 417), with the partners each receiving their proportionate share of the stock issued by the corporation. Upon a sale of some of such stock by the taxpayer, the amount of his recognizable gain depended upon his holding period on the stock and he was entitled to tack onto his holding period on the stock the period for which he had held the property exchanged for the stock. The taxpayer contended that the property he exchanged for the stock was his partnership interest and the Tax Court held that the property exchanged was his interest in the specific assets of the partnership. The Third Circuit viewed the case as presenting a question on the evidence and decided the case accordingly, holding that (pp. 421, 422):

> From the above it is clear that the subject matter of the *direct* exchange between the partnership and the corporation was the partnership interest in the entire business and its physical assets, real and personal and good will *as a going concern.*
>
> *   *   *   *   *
>
> Simply stated, what happened here was an incorporation by the partners of their partnership business. * * *
>
> *   *   *   *   *
>
> Here clearly the petitioner and his copartners acting in concert gave up his partnership interest in exchange for the stock of the corporation.

The *Thornley* decision gives a semblance of support to taxpayers' general position that the sale of a partnership business may (not does) constitute the sale of the partners' partnership interests, but the case not only is distinguishable from the present case in an important respect, as we shall show presently, but it is a decision which should be limited in its application. The question there presented was simply what the taxpayer *as an individual* had exchanged for the stock. If he had no individual interest in the assets of the partnership (as the other cases discussed above hold), on the facts of the case he necessarily could only have exchanged his interest in the firm, which is what the *Thornley* decision assumed to be a partnership interest. The Third Circuit, which decided the *Thornley* case, has since held that the partners are the individual owners of the partnership assets and that a partnership is not a legal entity.

In *Randolph Products Co.* v. *Manning, supra,* the Third Circuit had before it a case in which the corporate taxpayer's stock was all owned by a husband and wife who were also members of a partnership from which the corporation received rent. The question was whether the rent received by the corporation from the partnership was personal holding company income within the meaning of Section 502 (f) of the Code as having been received from "an individual entitled to the use of the property." The Third Circuit stated (pp. 192–193):

> The crux of the taxpayer's position is that (1) a partnership is a separate and distinct business unit or entity; (2) where a partnership is a tenant it is the partnership which is "entitled to the use of the property;" * * *
>
> We cannot subscribe to the taxpayer's view. Under both the Internal Revenue Code and the applicable local law a partnership is not an entity separate and distinct from the individual partners.
>
> While it is true that the Code for certain informational and accounting purposes requires the filing of partnership returns the partnership is merely a tax computing unit and is not a taxpayer or a taxable entity. * * *
>
> The concept of a partnership as an entity, owning property apart from its partners was rejected by the Second Circuit in *Commissioner* v. *Whitney,* 1948, 169 F. 2d 562, certiorari denied 335 U. S. 892, * * *. In that case losses sustained on the sale of partnership assets to a corporation controlled by the partners and organized by them to take over the part-

nership business were held non-deductible under Section 24 (b) (1) (B) of the Internal Revenue Code which disallows losses between "an individual" who owns more than 50 percent of a corporation's stock, and such corporation, except in the case of distributions and liquidations.

The Court in the *Whitney* case held that neither the revenue laws nor the Uniform Partnership Act (effective in New York) contained the slightest basis for recognition of the partnership as a taxable entity. * * *

* * * * *

After an exhaustive review of the subject the Court stated its conclusion as follows, 169 F. 2d at page 568: "There is no doubt that generally speaking under the tax law we must approach the partnership as an association of individuals who are co-owners of its specific property and who are taxed, while the partnership is not."

We deem the *Whitney* case analogous to the situation here presented and we subscribe to the holding therein. Any further discussion would be repetitious in view of the comprehensive analysis made by the Second Circuit. Accordingly we are of the opinion that the income of a corporation derived exclusively from the rental of its property to a partnership consisting of husband and wife who own all of the corporation's capital stock is "personal holding company income" within the meaning of Section 502 (f).

Accordingly, the Third Circuit has now adopted the view which it rejected in the *Thornley* case—that a

partnership is not a legal entity but, instead, the partners are the individual owners of the partnership property. The *Thornley* decision, if not now incorrect under the same court's decision in *Randolph Products Co.* v. *Manning, supra,* certainly at least must be limited in its application to the question involved in the *Thornley* case, which was simply what the taxpayer *as an individual* had exchanged for the stock.

The *Whitney* decision of the Second Circuit, which taxpayers cite but do not discuss (Br. 14) and which was relied upon by the Third Circuit in *Randolph Products Co.* v. *Manning, supra,* is opposed to taxpayers' contention that the sale of a partnership business constitutes the sale of a single capital asset. In the *Whitney* case, as in the *Thornley* case, the partners incorporated their business. In the assets transferred by the firm to the corporation certain securities showed a gain in value over their cost, while others showed a loss, and the partnership had both long-term and short-term capital losses. The inquiry was whether the capital losses of the partnership were deductible by the partners. Because Section 24 (b) (1) (B) of the Code (26 U. S. C. 1946 ed., Sec. 24) prohibits any deduction for losses from sales or exchanges of property between an individual and a corporation whose stock is more than 50 per cent owned by or for him, the taxpayer-partners contended that the partnership was an entity, owning and transferring property apart from its partners, and that, therefore, Section 24 (b) (1) (B) did not prohibit the deductions. The Second Circuit held otherwise

in an opinion which discussed the subject at length. As to its decision in the *Lehman* case, on which taxpayer relies and which we have already mentioned, the court stated (pp. 567–568):

> That case applied the unitary concept of a partnership to the extent of reaching a result which, we agree, was in line with ordinary business conceptions and the there practical statutory intent. * * *
>
> * * * However justified we have been in following business practices to treat a share of the firm itself apart from the individual interests, *Commissioner of Internal Revenue* v. *Lehman, supra,* we cannot find justification in the precedents and the statute for carrying the rule so far as to apply it by analogy to the ownership of specific property or to disregard the direct specifications of individual ownership of partnership property. * * *

Thus the *Whitney* case was a case of the sale of a partnership business in which the sale was recognized as being of the assets of the partnership (not of the partners' partnership interests) and the partners were assumed to be taxable on the partnership assets according to the nature of the gain or loss on each asset but were not entitled to deductions for capital losses on the sale because of the specific prohibition of Section 24 (b) (1) (B).

Up to this point we have been discussing taxpayers' general position that the sale of a partnership business constitutes a sale of the partners' partnership interests. Since the sale of a partnership business is nothing more than a sale of partnership assets and

does not terminate a partner's status as a partner, the sale is necessarily of partnership assets, not of the partners' partnership interests, and the tax consequences are that, by virtue of the express provisions of Section 182 of the Code, the partners are taxable on the gain from the sale as though they were the individual owners of the partnership assets. Regardless of whether they actually are or not, that conclusion, as we have attempted to show, is in no way inconsistent with the decisions holding that the sale of a partnership interest by one partner to another constitutes the sale of a single capital asset.

If it nevertheless be assumed, on the basis of the *Thornley* decision, that the sale of a partnership business *may* constitute a sale of the partners' partnership interests, it then becomes important to determine *when* the sale of a partnership business constitutes a sale of the partnership interests. As already stated, if the partners are not regarded as the individual owners of the partnership assets, their partnership interests necessarily consist of an interest in the partnership firm as an entity (in line with the earlier cases, as distinguished from the *Whitney* case and *Randolph Products Co.* v. *Manning, supra*) and, hence, of a right to share in the profits and surplus of a firm *as a going concern with assets, a name and good will*. That much is evident from the *Shapiro* decision, *supra*. The *Thornley* decision is consistent with the *Shapiro* case in that connection, for in the *Thornley* case the transfer from the partnership to the corporation was of the following (p. 418):

> the entire plant, property, machinery, equipment, fixtures, business and *good will* of the N. W. Ayer & Son partnership including all book accounts and accounts receivable outstanding, contracts, copyrights, trade marks, claims, causes of action, and *all rights and all assets and property of any kind or nature whatsoever belonging or appertaining to the said partnership and to the business thereof,* subject, however, to all the adjustments to be made as more fully set forth in said Agreement of April 23rd, 1929, and further subject to all outstanding liabilities and indebtedness of said partnership, which the said corporation, N. W. Ayer & Son, Incorporated, hereby assumes, * * * [Italics supplied.]

Moreover, in the *Thornley* case it appears that the court regarded the following conclusion as factually decisive (p. 421):

> From the above it is clear that the subject matter of the *direct* exchange between the partnership and the corporation was the partnership interest in the entire business and its physical assets, real and personal and good will *as a going concern.*

Contrary to taxpayers' contention (Br. 12–13), the instant sale was not of their interests in the partnership firm as a going concern. The business of the partnership, conducted under the name of Hatch Chevrolet Company, was the selling, distributing, repairing and service of motor vehicles both at wholesale and retail and the business was conducted under a franchise from the Chevrolet Motor Division of General Motors Corporation. (R. 69.) On the sale

to Chase, the partnership (or taxpayers as partners) did not authorize Chase to use the partnership firm name, except for a limited time to enable him to make the necessary arrangements for the future title or trade name of the business. (R. 69–70.) The sale covered only tangible personal property and did not include good will. Further, the sale did not cover the Chevrolet franchise, which taxpayers state (Br. 9) was nontransferable. Thus, all that happened was that Chase purchased most of the stock and equipment of the partnership and thereafter conducted a garage business, apparently on the same premises as the partnership before him. The going concern business conducted by the partnership firm was a business conducted under a Chevrolet franchise and Chase did not receive the franchise on the sale. For all that appears from the record, Chase may not even have sold Chevrolets. Nor did Chase receive any benefit from the fact that the partnership had previously conducted a garage business on the same premises, assuming that he did conduct it on the same premises and even also assuming that Chase secured a Chevrolet franchise for himself. The change in ownership and necessary change of name of the business conducted on the premises made it impossible for him to derive any good will benefit from the previously conducted partnership business. That was recognized by the fact that the sale did not cover good will. The necessary conclusion is simply that the partnership (or taxpayers as partners) sold and Chase bought personal property, such as equipment, parts, cars, etc., with which to conduct a garage

business. Certainly, the partnership did not sell and Chase did not receive any interest in or from the partnership firm as an established business or going concern. Contrary to taxpayers' argument (Br. 24), it is immaterial that the partnership discontinued its garage business and that Chase began operation of a garage business with substantially the same equipment and stock. The sale could not be of taxpayers' interest in the partnership when it was not of taxpayers' interest in the partnership firm *as an established business or going concern.*

CONCLUSION

The decisions of the Tax Court are correct and should be affirmed.

Respectfully submitted.

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APPENDIX

Internal Revenue Code:

SEC. 117. CAPITAL GAINS AND LOSSES.

(a) *Definitions.*—As used in this chapter—

(1) *Capital assets.*—The term "capital assets" means property held by the taxpayer (whether or not connected with his trade or business), but does not include stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business, or property, used in the trade or business, of a character which is subject to the allowance for depreciation provided in section 23 (1), * * *

* * * * *

(4) [as amended by Sec. 150 (a) (1) of the Revenue Act of 1942, c. 619, 56 Stat. 798] *Long-term capital gain.*—The term "long-term capital gain" means gain from the sale or exchange of a capital asset held for more than 6 months, if and to the extent such gain is taken into account in computing net income.

* * * * *

(b) [as amended by Sec. 150 (c) of the Revenue Act of 1942, *supra*]. *Percentage taken into account.*—In the case of a taxpayer, other than a corporation, only the following percentages of the gain or loss recognized upon the sale or exchange of a capital asset shall be taken into account in computing net capital gain, net capital loss, and net income:

100 per centum if the capital asset has been held for not more than 6 months;

50 per centum if the capital asset has been held for more than 6 months.

* * * * *

(26 U. S. C. 1946 ed., Sec. 117.)

SEC. 181. PARTNERSHIP NOT TAXABLE.

Individuals carrying on business in partnership shall be liable for income tax only in their individual capacity. (26 U. S. C. 1946 ed., Sec. 181.)

SEC. 182 [as amended by Sec. 150 (g) (1) of the Revenue Act of 1942, supra]. TAX OF PARTNERS.

In computing the net income of each partner, he shall include, whether or not distribution is made to him—

(a) As part of his gains and losses from sales or exchanges of capital assets held for not more than 6 months, his distributive share of the gains and losses of the partnership from sales or exchanges of capital assets held for not more than 6 months.

(b) As part of his gains and losses from sales or exchanges of capital assets held for more than 6 months, his distributive share of the gains and losses of the partnership from sales or exchanges of capital assets held for more than 6 months.

(c) His distributive share of the ordinary net income or the ordinary net loss of the partnership, computed as provided in section 183 (b). (26 U. S. C. 1946 ed., Sec. 182.)

SEC. 183. COMPUTATION OF PARTNERSHIP INCOME.

(a) [as amended by Sec. 9 (c) (1) of the Individual Income Tax Act of 1944, c. 210, 58 Stat. 231] *General Rule.*—The net income of the partnership shall be computed in the same manner and on the same basis as in the case of an individual, except as provided in subsections (b), (c), and (d).

(b) [as amended by Sec. 150 (g) (2) (A) of the Revenue Act of 1942, *supra*]. *Segregation of items.*—

(1) *Capital gains and losses.*—There shall be segregated the gains and losses from sales or exchanges of capital assets.

(2) *Ordinary net income or loss.*—After excluding all items of gain and loss from sales or exchanges of capital assets, there shall be computed—

(A) An ordinary net income which shall consist of the excess of the gross income over the deductions; or

(B) An ordinary net loss which shall consist of the excess of the deductions over the gross income.

(*c*) *Charitable contributions.*—In computing the net income of the partnership the so-called "charitable contribution" deduction allowed by section 23 (o) shall not be allowed; but each partner shall be considered as having made payment, within his taxable year, of his distributive portion of any contribution or gift, payment of which was made by the partnership within its taxable year, of the character which would be allowed to the partnership as a deduction under such section if this subsection had not been enacted.

(d) [as amended by Sec. 9 (c) (2) of the Individual Income Tax Act of 1944, *supra*]. *Standard deduction.*—In computing the net income of the partnership, the standard deduction provided in section 23 (aa) shall not be allowed. (26 U. S. C. 1946 ed., Sec. 183.)

SEC. 188. DIFFERENT TAXABLE YEARS OF PARTNER AND PARTNERSHIP.

If the taxable year of a partner is different from that of the partnership, the inclusions with respect to the net income of the partnership, in computing the net income of the partner for his taxable year, shall be based upon the net income of the partnership for any taxable year of the partnership (whether beginning on, before, or after January 1, 1939) ending within or with the taxable year of the partner. (26 U. S. C. 1946 ed., Sec. 188.)

Treasury Regulations 111, promulgated under the Internal Revenue Code:

> SEC. 29.182–1. DISTRIBUTIVE SHARE OF PARTNERS.—(a) Each partner is required to include in his return for his taxable year within which or with which the taxable year of the partnership ends, whether or not distributed:
>
> (1) As part of his gains and losses from sales or exchanges of capital assets held for not more than six months, his distributive share of the gains and losses of the partnership from sales or exchanges of capital assets held for not more than six months.
>
> (2) As part of his gains and losses from sales or exchanges of capital assets held for more than six months, his distributive share of the gains and losses of the partnership from sales or exchanges of capital assets held for more than six months.
>
> (3) His distributive share of the ordinary net income or the ordinary net loss of the partnership, computed as provided in section 183 (b).
>
> *   *   *   *   *
>
> SEC. 29.183–1. COMPUTATION OF PARTNERSHIP INCOME.—The net income of the partnership shall be computed in the same manner and on the same basis as the net income of an individual, except that:
>
> (1) The partnership is required to segregate its gains and losses from sales or exchanges of capital assets. A partnership is not allowed the benefit of section 117 (e).
>
> (2) The partnership is further required, after excluding all items described in paragrap (1), to compute (a) an ordinary net income which consists of the excess of gross income over the deductions, or (b) an ordinary net loss which consists of the excess of the deductions over the gross income. * * *

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